**Franchise Tax Board**

# ANALYSIS OF ORIGINAL BILL

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| Author: | Poochigian | Analyst: | Jeani Brent | Bill Number: | SB 1081 |
| Related Bills: | See Legislative History | Telephone: | 845-3410 | Introduced Date: | 02/26/1999 |
| | | Attorney: | Doug Bramhall | Sponsor: | |

**SUBJECT**: Sales Factor/Tangible Personal Property/Modify Source Rules

SUMMARY

Under the Bank and Corporation Tax Law, this bill would modify the rules regarding the source of income from sales of tangible personal property. Specifically, this bill would remove from the "throw-back" rule sales to the United States Government.

EFFECTIVE DATE

This bill would apply to income years beginning on or after January 1, 1999.

LEGISLATIVE HISTORY

California adopted the Uniform Division of Income for Tax Purposes (UDITPA) in 1966 (AB 11, Stats. 1966, Ch. 2). The source rules for tangible personal property later were modified to require corporations to include in their income any sale of unprocessed timber that is a softwood. (AB 2925, Stats. 1994, Ch. 1296.) This inclusion will be repealed by its provisions on December 1, 2000.

SPECIFIC FINDINGS

**The U.S. Constitution**, through judicial interpretation of the due process and commerce clauses, limits the taxing power of the individual states. Based on the due process clause, court cases have established that there must be (1) a definite link between the state and the person, property, or transaction being taxed and (2) a relationship between the income attributed to the state and the values connected with the state. When a sufficient connection exists between the state and the person being taxed, the person has nexus with the state. Under the commerce clause, a state tax must be (1) applied to an activity with a substantial nexus to the taxing state, (2) fairly apportioned, (3) nondiscriminatory, and (4) fairly related to the benefits provided by the state.

**Federal law**, under Public Law 86-272, prohibits states from imposing an income tax (direct or indirect) upon a person or entity whose only activity in the state is solicitation of orders for sales of tangible personal property, where the orders are sent outside the state for approval and, if approved, are filled and delivered from a stock of goods located outside the state.

**Existing state law** requires corporations with activities both inside and outside California to combine all activities when determining business income apportionable to the state for tax purposes.

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Under the worldwide unitary method, the income of related affiliates that are members of a unitary business is combined to determine the total income of the unitary group. A share of the income then is apportioned to California on the basis of relative levels of business activity in the state.

**Existing state law** allows corporations to elect to determine their income on a “water's-edge” basis. Corporations that elect water's-edge treatment generally can exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources.

**Under existing state law**, the general rule applicable to most corporations requires a four-factor apportionment formula, which is the average of property, payroll, and double-weighted sales. These factors are then divided by four. Each factor is the ratio of in-state activity (numerator) to worldwide activity (denominator). Corporations in agricultural, extractive, savings and loan, and banking and financial business activities use a three-factor apportionment formula, which is the average of three factors – the sales factor is single-weighted.

Property represents the capital investment in the business by the participants, payroll represents the contributions of labor to the earning of income, and sales represents market contributions. Sales generally are assigned on a destination basis. A sale of tangible personal property is sourced in California if:

1. The property is delivered or shipped to a purchaser in California, unless the purchaser is the United States government.
2. The property is shipped from an office, store, warehouse, factory, or other place of storage located in California, and:
   A. the taxpayer is not taxable in the purchaser’s state, or
   B. the purchaser is the U.S. government

The second rule is called the "throw-back" rule, whereby sales that are made to a customer in a state where the taxpayer is not taxable are thrown back to the state from which the goods were shipped. The rationale for this approach is that all income should be assigned to some jurisdiction that can tax it. Thus, if the income cannot be taxed in the destination state, it is thrown back to the state with the next closest connection, the state from which the goods were shipped. Sales to the U.S. government were made subject to the throw-back rule because it is difficult to attribute them to any individual state.

Under these existing rules, sales to the U.S. government and other purchasers can be treated basically five basic ways for sourcing purposes:

1. Goods manufactured in California and delivered to a purchaser in California, regardless of whether the purchaser is the U.S. government, are sourced to California.
2. Goods manufactured in California and delivered to a purchaser, other than the U.S. government, in a state where the taxpayer <u>is taxable</u> are sourced to the destination state. If the purchaser is the U.S. government, the sale of goods are sourced to California as a result of the throw-back rule.
3. Goods manufactured in California and delivered to a purchaser, regardless of whether the purchaser is the U.S. government, in a state where the taxpayer <u>is not taxable</u> are sourced to California as a result of the throw-back rule.

4. Goods manufactured in another state and delivered to a purchaser in California where the taxpayer is taxable in California are sourced to California. If the purchaser is the U.S. government, the sale of goods are sourced to the manufacturer's state.
5. Goods manufactured in another state and delivered to a purchaser in California where the taxpayer is not taxable in California are sourced to the manufacturer's state. This rule also applies if the purchaser is the U.S. government.

**This bill** would modify the rules regarding the source of income from sales of tangible personal property. Specifically, this bill would remove from the throw-back rule sales to the U.S. government.

**This bill** would change existing law as it applies only to sales to the U.S. government as follows:

1. Goods manufactured in California and delivered to the U.S. government in California no longer would be sourced anywhere.
2. Goods manufactured in California and delivered to the U.S. government in a state where the taxpayer is taxable no longer would be sourced to California and instead would be sourced to the destination state, presuming that the state of destination could be determined.
3. Goods manufactured in California and delivered to the U.S. government in a state where the taxpayer is not taxable would continue to be sourced in California because of the remaining throw-back rule, presuming that the state of destination could be determined.
4. Goods manufactured in another state and delivered to the U.S. government in California where the taxpayer is taxable in California would continue to be sourced to the manufacturer's state.
5. Goods manufactured in another state and delivered to the U.S. government in California where the taxpayer is not taxable in California would continue to be sourced in the manufacturer's state.

Policy Considerations

This bill raises the following policy considerations:

1. Assuming that all states adopted the rule contained in this bill, the sales described in the first, second, and the fourth circumstance under "Specific Findings" above, would not be sourced anywhere. Under the second and fourth circumstances, if the manufacturer's state adopted rules similar to this bill or any other rule that sourced the sale of goods to the U.S. government to the destination state, then the two state's rules each would attempt to source the sale to the other state, resulting in the sale being sourced nowhere.

   According to the State Corporate Taxation Of Sales to the Federal Government issued by the Legislative Analyst's Office, January 1999,[1] 19 states currently apportion corporate income from sales to the U.S government to the destination state. Of these 19, seven are among the top leading states in terms of federal government procurement expenditures.

[1] The Report was prepared in response to Senate Concurrent Resolution 44 (Stats. 1998, Ch. 157) regarding California's treatment of sales of tangible personal property to the U.S. government within its formula for apportioning corporate income to California.

Thus, under current circumstances, the potential exists for this bill to create nowhere sales under the second and fourth circumstance above, in addition to the nowhere sales created by this bill under the first circumstance.

2. In all circumstances a determination would have to be made as to where the sales are delivered, the problem the drafters of UDITPA were trying to avoid in adopting the current law rule applicable to sales to the U.S. government.

   Under UDITPA, states generally source sales to the state in which the purchaser is located; however, in the case of sales to the U.S. government, the destination of those sales often is unknown, thus the source of those sales are thrown back to the state of origin of the property. By eliminating this throw-back rule for California purposes, this bill would create a difference between California source rules and UDITPA rules, thereby creating the potential for "nowhere" income.

3. Under the bill, sales to the U.S. government could be given a complete exemption from the numerator of the California sales factor. As a result, any taxpayer that sells only to the U.S. government could have either 1/2 (in the case of a double-weighted sales factor) or 1/3 (single-weighted sales factor) of its income exempt from state tax. If the purpose of the bill is to fully eliminate the throw-back rule for sales to the U.S. government, then paragraph (1) of subdivision (a) also needs to be amended.

4. Under so-called "cost plus contracts," corporate taxpayers generally do not pay the state tax under the terms of the contract, but are reimbursed by the U.S. government. As a result, under this bill, since there could be no state tax reimbursement amount, the taxpayer's income base would be reduced.

### Implementation Considerations

To the extent that taxpayers and the department differ in determining the destination of sales to the U.S. government, this bill could result in disputes between taxpayers and the department.

## FISCAL IMPACT

### Departmental Costs

This bill would not significantly impact the department’s costs.

Tax Revenue Estimate

Based on the discussion below, the revenue impact under the Bank and Corporation Tax Law is estimated to be as follows:

| Effective Beginning on January 1, 1999 Enactment After June 30, 1999 (in millions) | | | |
|---|---|---|---|
| 1999-0 | 2000-1 | 2001-2 | 2002-3 |
| ($20) | ($25) | ($27) | ($28) |

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Estimate

The estimate is based on the State Corporate Taxation Of Sales to the Federal Government (the report) issued by the Legislative Analyst's Office (LAO), January 1999.

The report, which was based in part on available tax return information provided by the department for the aerospace industry, addresses various options to the apportionment formula for modifying both numerator and denominator values. Based on the same data and methodology used for those specific estimates in the report, the LAO has indicated that this bill would result in revenue losses on the order of $22 million for the initial year, without regard to the remaining throw-back rule based on the taxpayer's taxable status in the destination state. However, the department assumes the revenue savings from the remaining throw-back rule would be minor since most taxpayers would have a taxable presence in the destination state. A 7% annual growth rate was used for the out-year estimates.

BOARD POSITION

Pending.